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IN THE
# Supreme Court of the United States

MARRITA MURPHY,

*Petitioner,*

v.

INTERNAL REVENUE SERVICE
and UNITED STATES OF AMERICA,

*Respondents.*

*On Petition For A Writ Of Certiorari*
*To The United States Court Of Appeals*
*For The District Of Columbia Circuit*

## REPLY BRIEF FOR PETITIONER

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## ARGUMENT

The "accession to wealth" test specifies that in order for damages to be within the scope of the "gross income" statute, 26 U.S.C. § 61(a), there must be some "accession" to the taxpayer's wealth. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 430 (1955). The Petition established that the D.C. Circuit's final decision conflicts with this controlling precedent and a long line of authorities holding that damages awarded to make a person "whole" or to restore a personal loss are not "income" or an "accession to wealth." Pet. 15-22. The brief in opposition responds by arguing that the court of appeals correctly decided that damages are taxable as income under Section 61(a), even though the Respondents concede that the D.C. Circuit "deemed it unnecessary to decide the question." U.S. Opp. 7, 10. That position is untenable. The court of appeals cannot, on the one hand, decide that Murphy's compensatory damages are taxable income under Section 61(a), while, on the other hand, avoid determining whether those damages are an "accession to wealth" under *Glenshaw Glass*. In either event, the D.C. Circuit's decision conflicts with *Glenshaw Glass* and the long line of authorities cited in the Petition. Review is warranted to resolve this conflict in accordance with the "accession to wealth" test.

Review is also warranted to address important questions of federal law resulting from the 1996 amendments to the personal injury exclusion, 26 U.S.C. § 104(a)(2). The type of compensatory personal injury damages at issue here are commonly awarded under numerous federal anti-discrimination and anti-retaliation statutes, as well

as in state tort actions. Although the scope of the personal injury exclusion was previously reviewed three times by this Court, there has been no guidance since Section 104(a)(2) was significantly altered in the 1996 amendments. Left unresolved are important questions such as whether "make whole" compensatory damages to restore personal injury losses are "income," and even if they are considered income whether physical injuries or physical sickness resulting from emotional distress are within the scope of the exclusion. Pet. 12-15, 31-36.

1.a. Respondents concede that Congress based the Code's definition of "income" in Section 61(a) on the term "incomes" in the Sixteenth Amendment. U.S. Opp. 10. However, Respondents ignore that from the enactment of the Revenue Act of 1913 through the passage of the first personal injury statutory exclusion in 1918, numerous court and administrative rulings held that personal injury damages, including compensatory damages for non-physical personal injury losses, are not "income." Cf. Pet. 12, 15-19, citing *O'Gilvie v. United States,* 519 U.S. 79, 84-87 (1996); *Glenshaw Glass,* 348 U.S. at 433 n. 8. *Also see, U.S. v. Kaiser,* 363 U.S. 299, 317-324 (1960) (Administrative tax rulings reprinted at Appendix Nos. 3, 4, 6, 7, 12, 14, 16 and 20). Consequently, the scope of the "gross income" statute and the subsequent versions of the personal injury statutory exclusions were expressly based on the limitations set forth in the Sixteenth Amendment. Any tax on damages that are not income is not a tax within the scope of those statutes and the Sixteenth Amendment.

b. The D.C. Circuit never held that compensatory damages for emotional distress and loss of reputation are "income" under the controlling "accession to wealth" test. *Glenshaw Glass, supra.*[1] Instead, the court of appeals initially held that Murphy's damages did not meet this test and were not "income," Pet App. 56-67, but after vacating that decision, the D.C. Circuit decided that Section 61(a) was amended "by implication" to include this type of non-physical personal injury damages as "gross income" without deciding the "accession to wealth" test required by *Glenshaw Glass.* Pet. App. 23. Simply put, gross income under Section 61(a) cannot include damages for non-physical injuries without satisfying the "accession to wealth" test. *See Glenshaw Glass, supra.*

c. Section 61(a) is a "gross income" statute. In order to tax Murphy's damages as income under that section the tax must satisfy the "accession to wealth" test, and it is not sufficient for the court of appeals to cite Congress' power under Article I in order to

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[1] Additionally, the D.C. Circuit's failure to address in its second decision the "In Lieu of What?" test conflicts with the approach used by several circuits to determine whether or not damages are taxable income. *Cf.,* Pet. 21; Pet. App. 58, citing *Raytheon Prod. Corp. v. Commissioner,* 144 F.2d 110, 113 (1st Cir. 1944); *Francisco v. United States,* 267 F.3d 303, 319 (3rd Cir. 2001); *Tribune Publishing Co. v. United States,* 836 F.2d 1176, 1178 (9th Cir. 1988); *Gilbertz v. United States,* 808 F.2d 1374, 1378 (10th Cir. 1987). That approach was also endorsed by this Court in *O'Gilvie,* 519 U.S. at 86, in asking whether damages are "a substitute for [a] normally untaxed personal ... quality, good or 'asset.'"

judicially create an excise tax "by implication."[2] First, no such excise tax on damages for non-physical injuries was ever enacted by Congress. Second, this case expressly involves the income tax under Section 61(a), not a tax-levying statute creating a new excise tax on damages.

By creating the fiction of an excise tax in this case, the court of appeals not only avoided the required "accession to wealth" test, but it upheld this imagined tax under the apportionment requirement of Article I, Section 9. *See* U.S. Const. Art. I, § 9, Cl. 4. However, even in analyzing its own judicially created tax, the D.C. Circuit failed to definitively hold that it was not a direct tax under Article I, Section 9, instead concluding only that the imagined tax was more akin to an excise tax than a direct tax. Pet. App. 33. In reaching this conclusion, the court of appeals failed to address that compensatory damages awarded to make a person "whole" for emotional distress and harm to reputation are compensation to restore personal injury losses. As such these damages are a substitute for diminished health and other personal losses. A tax on these damages falls directly on the person who is compensated for a distinctly human capital or personal injury loss. Since they cannot be shifted, the tax on these damages is a tax on the person.

Respondents conveniently ignore that in continuing its fiction of a judicially created excise

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[2] It is unnecessary to determine whether the tax is direct or indirect, because once it is established that the damages at issue are not an "accession to wealth" under *Glenshaw Glass*, there is no income within Section 61(a) and the Sixteenth Amendment.

tax, the court of appeals held that the excise was imposed on the "privilege" of using the "legal system" to "vindicate a statutory right." Pet. App. 36. To be sure, this is the first case in which any court has judicially created an excise tax on the right to use the legal system to vindicate a federal statutory right. However, the implications of such a tax on litigants are so enormous as to warrant review.

2.a. In *Burk-Waggoner Oil Ass'n. v. Hopkins*, 269 U.S. 110, 114 (1925), Justice Brandeis noted that "Congress cannot make a thing income which is not so in fact." Although the legislative history of the 1996 Act does not contain any text, aside from a heading, stating that the amended statute would include damages for non-physical injuries in income, even if Congress did "label" such damages as income in a committee report that does not make them so. *Cf., Burk-Waggoner Oil Ass'n.*, with Pet App. 20. As Respondents conceded, the statutory definition of income in Section 61(a) is based on the term "incomes" in the Sixteenth Amendment. U.S. Opp. 10. While there is no explanation as to how the court of appeals can expand the meaning of income in Section 61(a) beyond that expressly defined by Congress itself, and simultaneously ignore the holding of *Burk-Waggoner Oil Ass'n.*, those are not the only problems with the D.C. Circuit's decision. More importantly, the court of appeals determination that Congress can simply "label" something as income and tax it once again ignores the constraints set forth by this Court to define income in Section 61(a) by the "accession to wealth" test. *See Glenshaw Glass, supra.*

b. Respondents' attempt to show what the court of appeals failed to determine does not satisfy the

"accession to wealth" test of *Glenshaw Glass.* Notably, Respondents do not address the actual definition of "accession" that requires an addition to wealth or property (Pet. 19-20), or that the sole purpose of Murphy's damages were, as a matter of law, to make her "whole." Instead, the Respondents simply argue that since Murphy received damages they must have "increased her wealth by $70,000." U.S. Opp. 11. However, the Department of Labor determined that Murphy's health and reputation were diminished by that same amount, and there is no dispute that the sole purpose of the award was for the restoration of these losses.

A straightforward application of *Glenshaw Glass* to this case shows that Murphy's damages are not income because they were awarded to make her "whole" and to restore a personal injury or human capital loss. Murphy was not enriched by receiving "make whole" compensatory damages.

Moreover, it is not accurate for Respondents to state that such "make whole" personal injury damages "have always been considered 'income' under Section 61(a) and its predecessors...." U.S. Opp. 11. Respondents' contention is refuted by the Court's decisions in *Glenshaw Glass* and *O'Gilvie,* as well as by the long line of administrative rulings stating that such damages are "not income." *See, e.g., O'Gilvie,* 519 U.S. at 84-87; *Glenshaw Glass,* 348 U.S. at 433 n. 8; *U.S. v. Kaiser,* 363 U.S. at 310-311 (Frankfurter, J., concurring); *Id.,* 363 U.S. at 317-324 (Appendix Nos. 3, 4, 6, 7, 12, 14, 16 and 20).

Obviously, the D.C. Circuit did not believe that Murphy's damages were taxable under the "accession to wealth" standard in its first decision in this case. Pet App. 58-59. Although the court of

appeals avoided making any findings on the "accession to wealth" test in its second opinion, the result reached to tax Murphy's "make whole" damages violates the ruling in *Glenshaw Glass.*

c. That *O'Gilvie, Glenshaw Glass* and *Dotson v. United States,* 87 F.3d 682 (5th Cir. 1996), considered the personal injury statutory exclusion that existed before the 1996 amendments to Section 104(a)(2) does not alter those interpretations of the history of Section 104 and the history of Revenue Rulings and departmental rulings considered by those courts and cited in the Petition.[3] The fact remains that those court opinions recognized the "return of human capital" analogy was based on court rulings holding that after the Sixteenth Amendment was enacted, "a restoration of capital was not income; hence it fell outside the definition of income." *O'Gilvie,* 519 U.S. at 84.

3. Contrary to Respondents' assertion, the rule of construction cited in the Petition stating that amendments of tax levying statutes by implication are disfavored and any doubts about the validity of the tax should be construed against the Government and in favor of the taxpayer is applicable here. Pet. 22-25. The one case cited by Respondents, *White v. United States,* 305 U.S. 281 (1938), did not concern an amendment by implication or even the validity of a tax levying statute. Furthermore, *White* did not overrule the rule of construction cited in the Petition. Rather, in *White,* the Court examined a

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[3] Notably, the IRS and the Treasury Department have never issued any reasoning or interpretation to disregard the prior administrative rulings holding that damages for both physical and non-physical personal injuries are not income.

statute applying deductions from taxes, not whether the imposition of a tax was valid in the first instance. Whether capital losses are to be treated as ordinary losses or subject to limitations on the deduction of losses resulting from the sale or exchange of stock, the issue in *White,* is much different than the construction issue presented here.

While courts generally have the duty to resolve doubts, they are bound to resolve them in applying the correct legal standard. However, the D.C. Circuit applied a standard that conflicts with the rule of construction long-followed by this Court and by other circuits. Pet. 22-25. Judicially imposing a tax by implication is both unprecedented and dangerous. Respondents have not cited a singe case in which the courts have upheld a tax statute as amended by implication to support what the D.C. Circuit did in this case.[4]

4. As for Respondents' additional argument that the tax at issue is an indirect tax, the damages were awarded to compensate Murphy to restore her "human capital" lost to personal injury. Taxing damages awarded for a personal injury loss to restore or make whole human capital is a tax on human capital. Therefore, it is not a tax on some "transaction" but a direct tax on Murphy's personal health or her human capital. *Cf.* Pet App. 33. This is not analogous to the estate tax at issue in *Tyler v. United States,* 281 U.S. 497, 502 (1930), where the Court found there existed accessions or enlargement

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[4] Respondents' reliance on *United States v. Fausto,* 484 U.S. 439, 453 (1988), is unavailing. *Fausto* did not concern imposing a tax by implication, and the statutes at issue there were not amended or repealed by implication.

to the property rights of another, and the tax was indirect because it was imposed on the transfer of those rights which ripened at the time of death.

Moreover, the D.C. Circuit did not create these analogies "merely to illuminate the question whether the tax at issue ... is more akin to a tax on ownership of property, or to a tax on the use of property, a privilege, or a transaction." U.S. Opp. 15. Instead, the court of appeals constructed this analogy to support a judicially created tax on non-physical personal injury damages that was found to exist "by implication" and not actually enacted by Congress. There is no support for this construction of a judicially created excise tax in the legislative history to the 1996 amendments to Section 104(a)(2), and Respondents can cite none.

5. Whether Murphy received damages "on account of" personal physical injuries or physical sickness under *Comm'r. of Internal Revenue v. Schleier,* 515 U.S. 323, 336-337 (1995), is not a factbound determination. This is not a case about disputed facts. It is a case about the application of the relevant decisions of this Court to conceded facts. Notably, on the basis of the uncontested summary judgment record, the district court found that Murphy suffered physical injuries, including bruxism or permanent damage to her teeth, as a result of the harm inflicted by her former employer. Pet. App. 74, 85.

Not only does the D.C. Circuit's ruling conflict with *Schleier,* it also raises an important question of federal law concerning the application of Section 104(a)(2) in the large number of cases where a plaintiff suffers physical injuries resulting from non-physical stimuli or from emotional distress. *See,*

*e.g.*, Price, J. Thomas, "Practice Tips: Settlements and Judgments: Taxing Issues Remain," 50 B.B.J. 20 (Nov./Dec. 2006); Karpov, Margarita R., "Note: To Tax or Not to Tax – That is the Question in the Midst of Murphy v. I.R.S.," 23 Akron Tax J. 143, 172-174, 178-179 (2008).

More than "[t]en years after this change, many questions remain in the interpretation of 'physical'" in Section 104(a)(2). Price, 50 B.B.J. at 20. The IRS has not even revised its regulations to reflect the statutory change to Section 104(a)(2), *see* 26 C.F.R. § 1.104-1(c), and the "IRS' guidance is limited to a single private letter ruling (PLR200041022 (July 7, 2000))..." that is "sometimes referred to as the 'Job from Hell' ruling." *Id.* The 1996 amendment adding the word "physical" to Section 104(a)(2) continues to cause enormous confusion and uncertainty about the tax implications for plaintiffs and defendants alike because damages are often awarded for both physical injuries and emotional distress resulting from discriminatory or retaliatory acts.

6. Even in the absence of any conflicting decisions in the circuits, the unusual importance of the underlying issues is grounds for granting the writ.[5] Commentators and practitioners alike have

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[5] *See Massachusetts v. EPA*, 549 U.S. ___, 127 S.Ct. 617 (2007); *U.S. v. Kaiser*, 363 U.S. at 303 (granting certiorari because of the importance of the tax issues presented, including whether assistance from a strike fund was "within the concept of income under § 61(a)" of the tax code). *Also see, Alaska Dept. of Env. Conservation v. EPA*, 540 U.S. 461, 482 (2004); *Tahoe-Sierra Preservation Council, Inc. v. Tahoe Regional Planning Agency*, 535 U.S. 302, 307 (2002); *National Credit Union Administration v. First National Bank & Trust Co.*, 522 U.S. 479, 487 & n.3 (1998).

long struggled with the application of Section 104(a)(2) and given the number of compensatory damages awards, "the taxation of damages is an important topic." *See, e.g.,* Palmer, Timothy R., "Note: Internal Revenue Code Section 104(a)(2) and the Exclusion of Personal Injury Damages: A Model of Inconsistency," 15 J. Corp. L. 83, 127 (1989). The D.C. Circuit's second decision in this case has not quelled the criticism, adequately corrected the problems or resolved the uncertainty resulting from the 1996 amendment. Commentators have written that the D.C. Circuit's approach was "a result-driven analysis" and "created even more controversy." Karpov, 23 Akron Tax. J. at 182-184.

Unquestionably, the court of appeals decided an important question of federal law in a manner that calls for this Court's review. The taxing of personal injury damages in light of the 1996 amendments to Section 104(a)(2) affects not only the tax bar, but impacts employment law, torts, whistleblower law, and civil rights. Review is needed to resolve whether "make whole" personal injury damages are not income and not taxable.

## CONCLUSION

For the foregoing reasons, and for the reasons stated in the Petition, the writ for certiorari should be granted.

Respectfully submitted,

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